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SUBJECT: CORRECTED COPY: AUSTRALIAN BANKS: Strong Grow Stronger

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¶1. (SBU) SUMMARY. Australia's major banks are emerging from the global financial crisis with increased dominance in domestic markets. This is in part because non-bank lenders and smaller banks have been unable to secure securitized international funding, while government measures have favored leading banks - which are considered vital to fund the ongoing current account deficit and mounting levels of public debt. The top four banks are protected by the Government's "four pillars" policy of opposing their consolidation or outside purchase. However, international concerns over the sector's vulnerability are growing. END SUMMARY.

BANKS IN CLOVER? - THE OUTLOOK FOR AUSSIE BANKS

¶2. (SBU) Despite the economic downturn, the "Big Four" Australian banks (Commonwealth, Westpac, National Australia Bank (NAB) and Australia-New Zealand Bank (ANZ)) have increased market share and maintained high profit ratios while incurring low bad debts. All four of Australia's major banks hold a coveted AA credit rating shared with only five other retail banks globally. For the 2008 reporting period, the return on equity for the largest Australian banks was 17% and at year-end held 82% of total banking assets. The "big four" Australian banks are highly profitable and better positioned than their global peers, according to Moody's. The Australian Prudential Regulatory Authority (APRA) recently reported major Australian banks had a profit margin of 30.6% in 2008 (it was 12% for other domestic banks) according to.

¶3. (U) The big four earned 80% of the A$46.5 billion Australian banks made from interest charged on loans last year. In addition, fees and commissions (such as fees for late payments) came to A$21 billion (70% to the big four). The banks continue to build market share at the expense of non-banks and their smaller banking competitors - partly because their competitors have higher funding costs under the government guarantee. According to the Reserve Bank of Australia (RBA), the "big four" share of the mortgage market has risen to 92.5% from 79.7% in 2007. Meanwhile, foreign bank assets fell to A$103 billion in March 2009 (down from A164 billion at end-2008) as a number of foreign lenders withdrew from Australia.

Overall, the apparent strength of Australia's banking system has been applauded globally and used as a benchmark for regulatory reform. Treasury Deputy Secretary David Gruen has suggested that the four-pillar policy has contributed to financial stability" because it prevented takeovers between the major banks "thereby reducing their incentives to become more highly leveraged".

GENEROUS GOVERNMENT POLICY MEASURES SUPPORT BIG BANKS

¶4. (SBU) The Australian Government has energetically supported the banking sector, particularly through the Government guarantee on bank deposits and on bank debt instituted in October 2008 immediately after the collapse of Lehman Brothers. Since November 2008, all bank deposits up to A$1 million received a free government guarantee; while depositors with over A$1 million pay a fee for the Qguarantee; while depositors with over A$1 million pay a fee for the guarantee. Similarly, banks can effectively borrow Australia's AAA sovereign rating to access lower cost funding on international money markets but must pay a fee based on their credit rating. The double "A" rated majors must pay 0.7% above the market interest rate, while a single "A" rated bank like Suncorp pays 1% and the Bank of Queensland, with its "BBB" rating, pays 1.5%.So far in 2009, the big four banks have raised around A$120 billion (US$100 billion) in new funding using the guarantee. Non-banking mortgage lenders are ineligible for the loan guarantee and a number have been absorbed into the banks. The smaller banks have therefore used the guarantee sparingly, although the major banks have raised more than $100 billion in new short-term and long-term debt at a cost of more than $200 million in fees. The higher cost for secondary lenders has allowed the big banks to expand their market share.

MOUNTING CONCERN OVER BANK FUNDING AND DEBT LEVELS

¶5. (SBU) In late June, the IMF advised the Government to limit its borrowing in case it needs to bail out the major Australian banks, which must roll over short-term international debts which exceed A$500 billion (SEP TEL). Similarly, Moody's ratings agency downgraded the entire bank sector because of rising bad debts and

falling consumer demand. The agency shifted its outlook on the Australian banking sector from "stable" to "negative". A key problem for bank funding is the low rate of savings in Australia (the average loan to deposit ratio for the Big Four is 153%, compared to 144% for UK banks and 110% for US banks) although the major banks hold 70% of total household savings. NAB CEO Cameron Clyne said Australia's reliance on foreign capital flows "beyond its capacity to save" needed to be addressed. Further, many of our contacts believe that Australian banks are particularly vulnerable to a downturn in the commercial property sector due to the likely fall in property values. Macquarie Bank has forecast that the tier-one capital ratios of the majors will fall from 8-9% to 7% as a result of debt problems stemming from commercial property and rising unemployment.

SINKING POPULARITY OF BANKS IN AUSTRALIA

¶6. (SBU) Given the extent of government guarantees and other assistance for major banks, there has been escalating annoyance with recent small increases in interest rates, bank involvement in financial scandals and growing fees and charges. The Commonwealth Bank's recent decision to raise its mortgage rates by 0.1% (on the grounds that it faced sharply higher costs), it was criticized by Prime Minister Rudd as a "selfish" action that undermined the federal government's support for the economy. Most Australians fund their home purchases through adjustable rate mortgages, and small interest rate adjustment can have significant microeconomic impact. The RBA also published a report which suggested that bank margins were still robust - despite the banks' claims of higher funding costs. Political support for the banks may be waning and in late June, Senator Steve Fielding introduced legislation to tighten controls on home loan interest rates in return for the deposit guarantee. The declining popularity of the banks could moderate government support for the sector.

¶7. (SBU) COMMENT: There are different perspectives on the dominance of the major Australian banks, but it is clear that the Rudd government has provided extensive support because of their critical role in financing Australia's current account deficit. This has meant overlooking competition policy concerns and the imposition of unpopular bank charges. Nevertheless, Australia's low level of savings (which has led banks to depend on overseas borrowing) remains an ongoing problem which creates a degree of sovereign risk if wholesale funding is less available, or costs increase. Our Government and market contacts are largely confident that the comparatively strong performance of Australia's banks as well as its overall economy makes the risks manageable, but the latest outside warnings are likely to be sobering. END COMMENT.

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